Supreme Court, U.S.
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No. 95-447

IN THE
# Supreme Court of the United States
OCTOBER TERM, 1995

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NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.,
*Petitioner,*

v.

AMERICAN MEDICAL INTERNATIONAL, INC.,
*Respondent.*

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**On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit**

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## BRIEF IN OPPOSITION

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## COUNTERSTATEMENT OF THE QUESTIONS PRESENTED

1. Whether a federal court, exercising diversity jurisdiction, complies with the requirements of *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938), when it affirms a jury's verdict of state-law breach of contract that is consistent with the substantial evidence, settled principles of state law, and the federal court's own precedent?

2. Whether this Court must grant the petition, vacate the judgment below, and remand for further consideration when (i) the state supreme court has rendered a decision that is not controlling as to the facts and issues of law presented below; and (ii) the court of appeals below has denied a motion for leave to file a petition for rehearing and suggestion for rehearing *en banc* in light of that state supreme court decision?

## PARTIES TO THE PROCEEDINGS AND RULE 29 STATEMENT

All parties are listed in the caption. Respondent American Medical International, Inc. is wholly-owned by American Medical Holdings, Inc. Respondent has two non-wholly-owned subsidiaries: Amisub of Texas, Inc. and New Holdings Corp.

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**On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit**

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## BRIEF IN OPPOSITION

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Respondent American Medical International, Inc. ("American Medical") submits this brief in opposition to the Petition for a Writ of Certiorari submitted by National Union Fire Insurance Company of Pittsburgh, Pa. ("National Union").

## STATEMENT OF THE CASE

This is a state-law action for breach of a contract of insurance. Petitioner, National Union, seeks review of the United States Court of Appeals for the Ninth Circuit's unpublished and unanimous decision affirming the jury's verdict in favor of Respondent American Medical. The jury concluded after a trial on the merits that National Union breached its contract of insurance issued to American Medical and that National Union violated the duty

of good faith and fair dealing owed to American Medical. The jury awarded American Medical damages of $11 million on the bad faith claim, along with $1 million in attorneys' fees. Petitioner's Appendix ("Pet. App.") 12a-14a.

The Ninth Circuit affirmed the verdict and the judgment in an unpublished and unanimous memorandum decision. Pet. App. 1a-11a. The Ninth Circuit denied National Union's timely petition for rehearing. Pet. App. 16a. On August 4, 1995, the Ninth Circuit granted a 60-day stay of its mandate pending the filing and disposition of National Union's petition for a writ of certiorari to this Court. Pet. App. 17a. Simultaneously with filing its petition before this Court, Petitioner filed a motion with the Ninth Circuit seeking leave to file an untimely petition for rehearing, along with a petition for rehearing and a suggestion for rehearing *en banc*, pursuant to Fed. R. App. P. 26(b), 35 & 40(a), in light of the California Supreme Court's decision in *Waller v. Truck Insurance Exchange*, 11 Cal. 4th 1, 44 Cal. Rptr. 2d 370 (1995).

By order filed on October 6, 1995, the Ninth Circuit denied Petitioner's motion for leave to file the untimely petition.[1]

**Factual Background**

American Medical owns and operates hospitals and medical research facilities. Pet. App. 2a.[2] In 1988,

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[1] The Ninth Circuit's order is unreported and is reprinted in the appendix hereto ("App.") at 1a. Petitioner's Motion for Leave to File Untimely Petition for Rehearing; Petition for Rehearing and Suggestion for Rehearing En Banc is reprinted at App. at 2a.

[2] Citations in support of this Factual Background are made either to the Ninth Circuit's memorandum decision below, reproduced in the Petitioner's Appendix ("Pet. App."), to the Excerpts of Record filed by National Union with its opening brief before the Ninth Circuit ("EOR"), or to the Supplemental Excerpts of Record filed by American Medical with its brief before the Ninth Circuit ("SUPP").

American Medical purchased two insurance policies to reimburse American Medical should it have to indemnify its directors and officers for claims brought against them in their corporate capacities. *Id.* The first policy, with a limit of $10 million, was issued by the Harbor Insurance Company (the "Harbor Policy"). *Id.* The second policy, with a limit of $5 million excess of $10 million, was issued by National Union (the "National Union Policy"). *Id.* The National Union Policy specifically identifies American Medical as the "Named Insured." *Id.*[3]

Beginning in 1988, American Medical received inquiries and then proposals from parties interested in buying the company. *Id.* The American Medical board of directors therefore formed a Special Committee, chaired by director Harold Williams ("Williams"), to establish procedures for the sale of the company and to review competing bids. *Id.* The Special Committee ultimately conducted an auction with three competing groups submitting proposals to acquire American Medical. *Id.* One of the unsuccessful bidders was an investment group (the "Pearce Group") headed by Lee Pearce ("Pearce"), a former American Medical director. Pet. App. 2a-3a.

In late March and early April of 1989, five class action lawsuits were filed on behalf of American Medical shareholders (the "shareholder actions") and one class action lawsuit was filed by bondholders (the "bondholder action") against American Medical and its current and former directors (collectively the "underlying litigation"), alleging breaches of fiduciary duty in connection with the acceptance of the successful bid for the company. Pet. App. 3a. On May 15, 1989, American Medical notified both Harbor and National Union of the underlying litigation. *Id.*; EOR 216-17. American Medical thereafter provided Harbor and National Union with documents and

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[3] The National Union Policy was an excess "following form" policy that incorporated the terms, conditions and coverage provisions of the underlying Harbor Policy. EOR 166.

information on a regular basis reflecting developments in the proceedings. SUPP 117; EOR 219-21.

On December 14, 1989, American Medical notified National Union of a cross-complaint filed in November of 1989 against American Medical and Williams by Pearce, Pet. App. 3a; EOR 219-21, 248-342, alleging that the Pearce Group had actually submitted a higher bid with fewer risks and fewer contingencies. EOR 311-12. Pearce claimed that Williams had rejected the bid because Williams had a personal animus toward Pearce. *Id.*, at 254.

Between the time of American Medical's notice to National Union in December 1989, and the trial of the Pearce action in June 1991, National Union did nothing to investigate or supervise the case. SUPP 96-97. National Union did not deny coverage or give American Medical any indication as to what position it might take on coverage. *Id.*, at 44-45. Although American Medical had regularly supplied National Union with pleadings, correspondence and memoranda, the National Union official assigned to the case testified at the trial below that he could not recall looking at the file more than once. *Id.*, at 9, 20, 97. The first time that National Union even attempted to reserve its rights occurred less than two weeks before the Pearce trial and consisted of a blanket statement that National Union was reserving "all of our rights" without any specification of the grounds for the reservation. *Id.*, at 6. National Union continued to equivocate as to coverage throughout the trial in this case. National Union's senior claims official testified by way of deposition read at trial that "*We never denied the claim and we are not denying the claim currently.*" *Id.*, at 88 (emphasis added).

While National Union continued to ignore the shareholder and bondholder actions and the Pearce action, American Medical was attempting to bring about a settlement. By letter dated May 31, 1991, American Medical

provided National Union with copies of correspondence in the shareholder actions and the Pearce action relating to settlement. EOR 223-35. American Medical's counsel also provided correspondence from counsel for Continental Insurance Company ("Continental"), the successor to Harbor, in which Continental authorized the use of the full $10 million Harbor Policy limits to settle the shareholder actions. Pet. App. 3a; EOR 234-35.

American Medical also requested that National Union authorize the use of the $5 million National Union Policy limits in the settlement negotiations. Pet. App. 3a; EOR 224. National Union flatly refused to participate in any settlement requiring National Union to pay money:

> "[W]e do not consent to *any settlement* on behalf of directors and officers for which reimbursement is sought under our policy." (Emphasis added.)

Pet. App. 3a; SUPP 6. American Medical and its directors entered into settlements with the plaintiffs in the shareholder actions, using proceeds from the Harbor Policy and a $1.5 million deductible paid by American Medical.[4] SUPP 76.

After National Union rejected American Medical's request to participate in settlement, Williams' attorney, Steven Wilson ("Wilson"), tried without success to obtain authority to use the National Union Policy limits to settle the Pearce action. Pet. App. 3a. On June 25, 1991, Wilson informed National Union that Pearce's counsel had offered to settle with Williams for $5 million, the limits under the National Union Policy. *Id.*; EOR 236. The offer was to remain open for 48 hours. EOR 236. Wilson asked for authority to accept the offer using the National Union Policy limits, but National Union refused again. SUPP 63.

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[4] The bondholder action has previously been dismissed on summary judgment. Pet. App. 3a n.1.

Thus, after doing nothing for more than 18 months, National Union rejected demands from both American Medical and Williams to use the National Union Policy limits for settlement of the Pearce action. EOR 223-24, 236-37. National Union also allowed a $5 million settlement demand to expire without responding. SUPP 8.

After rejecting these demands—and three weeks into the trial on the Pearce action—National Union's lawyer, Robert Lewis ("Lewis"), contacted Pearce's lawyer, Herb Hafif ("Hafif"), and proposed an arrangement, known as a Mary Carter agreement.[5] Pet. App. 3a. Under the terms of the agreement, National Union guaranteed that Hafif's client would recover $5 million in exchange for a dismissal of Williams from the lawsuit. *Id.*, at 4a. The amount guaranteed by National Union was to be reduced—dollar for dollar—by the amount Pearce recovered from American Medical. *Id.* Thus, if Pearce recovered at least $5 million from American Medical, then National Union paid nothing. *Id.*

National Union included a veto provision in the agreement in the event Pearce wanted to settle with American Medical. *Id.* Under this provision, Pearce could not settle with American Medical for less than $4 million without National Union's consent. *Id.* Any settlement with American Medical for less than $4 million would require Pearce to forfeit the $5 million guarantee. *Id.* National Union's lawyer testified at trial that the purpose of the veto provision was to make sure that Pearce and his lawyer continued to sue American Medical and

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[5] As the Ninth Circuit noted in its memorandum decision, "A 'Mary Carter' agreement is an arrangement between a plaintiff and a defendant whereby the exposure to liability of the settling defendant is limited, 'usually in some inverse ratio to the amount of recovery which the plaintiff is able to make against the non-settling defendant or defendants.'" Pet. App. 3a-4a n.2 (citing Black's Law Dictionary 974 (6th ed. 1990)).

to prevent a situation where "all of the [sic] sudden they fold up and say, 'We got five million [from National Union]. Let's go awa[illegible].'" SUPP 52.

Hafif insisted that the settlement be timed to occur when Williams was on the witness stand and under cross-examination by Hafif. *Id.*, at 54. Williams' lawyer testified that the reason for the timing was obvious:

> "That the plaintiff wanted to create a strategic effect in the courtroom that Mr. Williams was on the stand as a defendant, subjected to cross-examination, and was so concerned that he settled, disappeared as a defendant. They thought that would be a powerful motivator or implicit motivator for the jury." [6]

*Id.*, at 74.

When American Medical learned of National Union's deal with Pearce, including the veto provision and the settlement with Williams on the stand, American Medical vehemently objected. *Id.*, at 67. To prevent its insurance benefits from being eviscerated by the deal, American Medical proposed a compromise. *Id.*, at 27. Under American Medical's compromise, National Union would pay $2 million and American Medical would pay $3 million into an escrow account for the defense of Williams who would remain in the case. *Id.*, at 27-28; EOR 344-46. American Medical provided additional assurances of indemnification to Williams—both orally and in writing—to supplement the indemnification agreement already in effect. SUPP 18, 36; EOR 344.

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[6] Similarly, James Roberts, an expert witness, testified at trial that having Williams settle after being cross-examined by Hafif "makes it a much more dangerous case for AMI to continue on with the trial with everybody thinking that Williams has, you know, copped a plea or something. He basically admitted he made a mistake, he acted wrongfully and he paid some money to Mr. Pearce. That has strategic value to Mr. Hafif. It has tremendous strategic impact on AMI in trial tactics and it's very negative." *Id.*, at 104.

Williams strongly preferred the American Medical compromise. SUPP 72. However, National Union refused. *Id.*, at 29. American Medical then requested that National Union at least delay its deal with Pearce to avoid the prejudicial impact at trial of a settlement by Williams while he was on the stand. *Id.*, at 30. National Union refused again. *Id.* The National Union deal with Pearce went forward as planned.

Two weeks into jury deliberations, American Medical settled with Pearce for $16 million. Pet. App. 4a. Because that settlement exceeded the amount guaranteed by National Union to Pearce, National Union was relieved of any obligation to pay Pearce under the Pearce-National Union arrangement. SUPP 15. National Union therefore paid nothing, leaving American Medical to foot the bill for the entire settlement and defense. Pet. App. 4a; SUPP 32, 76-77.

**The Actions Below**

American Medical filed this diversity action in the United States District Court for the Central District of California, alleging claims for breach of contract and breach of the duty of good faith and fair dealing under California law. The jury concluded, after a trial on the merits, that National Union breached its contract and violated the duty of good faith and fair dealing owed to American Medical. The jury awarded American Medical damages of $11 million on the bad faith claim, along with $1 million in attorneys' fees. Pet. App. 12a-14a. After denying National Union's post-trial motions, the District Court entered judgment, Pet. App. 15a, and National Union appealed.

The Ninth Circuit affirmed the verdict and the judgment in an unpublished and unanimous memorandum decision. Pet. App. 1a. On July 13, 1995, the Ninth Circuit denied National Union's timely petition for rehearing. Pet. App. 16a. On August 4, 1995, the Ninth

Circuit granted a 60-day stay of its mandate pending the filing and disposition of National Union's petition for a writ of certiorari to this Court. Pet. App. 17a. Simultaneously with filing its petition before this Court, Petitioner filed a motion with the Ninth Circuit seeking leave to file an untimely petition for rehearing, along with a petition for rehearing and a suggestion for rehearing *en banc*, pursuant to Fed. R. App. P. 26(b), 35 & 40(a), in light of the California Supreme Court's decision in *Waller v. Truck Insurance Exchange*, 11 Cal. 4th 1, 44 Cal. Rptr. 2d 370 (1995). App. 2a.

By order filed on October 6, 1995, the Ninth Circuit denied Petitioner's motion. App. 1a.

## REASONS FOR DENYING THE WRIT

This case presents no issue appropriate for the Court's exercise of its discretionary jurisdiction. This is a straightforward diversity case. The Ninth Circuit affirmed a jury's breach of contract verdict that was based on substantial evidence and settled principles of state law. This Court has repeatedly declined to overrule reasoned decisions by federal courts skilled in the local law of the particular states in which they sit, and this case presents no basis for departing from that principle.

Moreover, contrary to Petitioner's contention, the jury's verdict and the Ninth Circuit's affirmance are not contrary to the California Supreme Court's decision in *Waller v. Truck Insurance Exchange*, 11 Cal. 4th 1, 44 Cal. Rptr. 2d 370 (1995). That decision provides no grounds for vacating the judgment below. In *Waller*, the insurer took no action beyond denying coverage for the uncovered claims presented by its insured. In this case, National Union did not deny coverage. Instead, under the guise of discharging its policy obligations, National Union affirmatively aligned its interests with those of a litigant adverse to American Medical, its own insured. Direct damage to American Medical resulted and American

Medical was deprived of the insurance benefits to which it was entitled. California and the Ninth Circuit precedent squarely supports the jury's finding of bad faith in this case. *Waller* does not hold otherwise. Indeed, the Ninth Circuit itself has already refused to reconsider its decision in this case in light of *Waller*. App. 1a. The petition accordingly should be denied.

## I. NO ISSUE OF INTER-CIRCUIT CONFLICT IS RAISED BY THE DECISION BELOW.

National Union asserts that this case presents the Court with the question of whether a federal court, exercising diversity jurisdiction, exceeds its authority when it "creates a new state law cause of action not previously recognized by the courts or authorized by the legislature of the State." Pet. at (i). Whatever might be the significance of that question, this case does not present it. Specifically, the fundamental premise of National Union's petition—that the Ninth Circuit in this case created a new California cause of action—simply is not correct. The court of appeals neither expressly nor impliedly engaged in what the petition terms an "*Erie* guess" in this case. Instead, the court applied established California and Ninth Circuit law and affirmed a jury verdict that was firmly based on the substantial evidence adduced at trial. This Court has prudently restrained from exercising its discretionary jurisdiction to review questions of state law that are better addressed by the federal judges who sit in the districts and circuit located in the state. No question requiring grant of the petition is raised here.

### A. The Ninth Circuit Followed The Dictates Of *Erie* In Affirming The Jury's Verdict Based On Established Precedent.

Petitioner has attempted to cast the Ninth Circuit's affirmance of the jury's verdict in this case as the invention of "an entirely new cause of action not previously recognized in California." Pet. at 6. From this erroneous

premise, Petitioner fashions the argument that certiorari must be granted in this case to resolve an alleged split among the federal circuit courts as to the appropriate role of a federal court addressing questions of state law when sitting in diversity.

However, this case does not present that question, because this is not an instance in which a federal court sitting in diversity has recognized a new cause of action unrecognized by the courts of the state in which the case arises.[7] Instead, as described below, the Ninth Circuit examined the facts of this case, the law of California and applicable Circuit precedent and affirmed the judgment squarely on those grounds.

In rejecting Petitioner's objections to the jury's verdict, the Ninth Circuit analyzed California cases, including decisions of the California Supreme Court and intermediate courts of appeal.[8] The Ninth Circuit also reviewed analogous decisions from other jurisdictions as well as a virtually identical Ninth Circuit case that relied on principles derived from California insurance law.[9] In doing so, the Ninth Circuit heeded this Court's dictate in *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938), and its progeny, that a federal court exercising diversity jurisdiction must

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[7] The Ninth Circuit is fully aware of the distinction between applying established state law and recognizing when state law on the issue presented is unsettled. *See, e.g., Torres v. Goodyear Tire & Rubber Co.*, 867 F.2d 1234, 1238 (9th Cir. 1989); *Paul v. Watchtower Bible & Tract Soc'y of New York*, 819 F.2d 857, 879 (9th Cir.), *cert. denied*, 484 U.S. 926 (1987). Unlike in those cases, here the Ninth Circuit applied existing California law and its own precedent to resolve the issues presented on appeal.

[8] *See* Pet. App. 5a-10a (citing, *inter alia*, *Commercial Union Assur. Cos. v. Safeway Stores, Inc.*, 610 P.2d 1038 (Cal. 1980), and *McMillin Scripps North Partnership v. Royal Ins. Co. of America*, 23 Cal. Rptr. 2d 243, 247 (Cal.Ct.App. 1993), *rev. denied*, 1994 Cal. LEXIS 552 (Cal. Feb. 3, 1994)).

[9] *Matison v. Transamerica Title Ins. Co.*, 845 F.2d 867 (9th Cir. 1988) (discussed *infra*).

follow the substantive law of the state in which the action was brought. The Ninth Circuit satisfied this obligation by "look[ing] to all available data," *State Farm Mut. Auto Ins. Co. v. Davis*, 937 F.2d 1415, 1418 (9th Cir. 1991), including decisions of a state's highest court, intermediate court decisions, and well-reasoned decisions from other jurisdictions. *Id.*

Accordingly, the appropriate question presented by this case is whether a federal court, exercising diversity jurisdiction, complies with the requirements of *Erie R.R. v. Tompkins* when it affirms a jury's verdict of breach of contract that is consistent with the substantial evidence, settled principles of state law, and the federal court's own precedent. This is a question which this Court has prudently determined is not appropriate for review. *See, e.g., Butner v. United States*, 440 U.S. 48, 57-58 (1979) ("[t]he federal judges who deal regularly with questions of state law in their respective districts and circuits are in a better position than we to determine how local courts would dispose of comparable issues"); *Bishop v. Wood*, 426 U.S. 341, 346 and n.10 (1976) (construction of state law by federal district court and court of appeals would not be reviewed, as " 'we are hesitant to overrule decisions by federal courts skilled in the law of particular states unless their conclusions are shown to be unreasonable' ") (internal citations omitted). In this case, the jury's verdict, the District Court's judgment and the Ninth Circuit's affirmance were all based on a correct application of state law. This Court should deny Petitioner's invitation to upset that analysis in this case.

### B. The Ninth Circuit Correctly Applied The Law In This Case.

National Union's assertion that the Ninth Circuit created a new California cause of action is not correct. The Ninth Circuit affirmed the jury's finding of bad faith based on the substantial evidence, California law and the almost identical precedent contained in its decision in

*Matison v. Transamerica Title Ins. Co.*, 845 F.2d 867 (9th Cir. 1988). In *Matison*, as in this case, the insurer entered into an agreement with the plaintiff against its insured -whereby the amount the insurer agreed to pay under its policy would be reduced dollar for dollar by any recovery that the plaintiff obtained on uncovered claims against the insured. The Ninth Circuit held that an insurer breaches the duty of good faith and fair dealing by entering into such an agreement, which furthers its own interests at the expense of its insured's interest: "Such connivance against one's insured is incompatible with the fiduciary-like duty an insurer . . . assumes by issuing a contract of insurance. Transamerica wrongfully placed 'paramount importance on its own interest.'" *Matison, supra*, at 868 (citations omitted).

National Union suggests that *Matison*, which is an Arizona case, cannot provide a basis under California law for the jury's finding of bad faith here. Pet. at 16. What National Union fails to note is that the principles of bad faith underlying the Ninth Circuit's decision in *Matison* are drawn primarily from California law. In ruling that the self-interested agreement negotiated by the insurance company in *Matison* was improper, the Ninth Circuit cited the Arizona Supreme Court case of *Rawlings v. Apodaca*, 151 Ariz. 149, 726 P.2d 565, 571, 573 (1986), and held that Transamerica had "a duty 'of a fiduciary nature' not to benefit at the expense of its insured." *Matison, supra*, at 868. The *Rawlings* court, in turn, relied on the *California* Supreme Court decision in *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 169 Cal. Rptr. 691 (1979), *cert. denied and appeal dismissed*, 445 U.S. 912 (1980), for the proposition that "the insurance contract and the relationship it creates contain more than the company's bare promise to pay certain claims when forced to do so; implicit in the contract and the relationship is the insurer's obligation to play fairly with its insured." *Rawlings, supra*, at 570-71. The *Rawlings* court also noted *Egan's* rule that "[c]on-

duct by the insurer which does destroy the security or impair the protection purchased breaches the implied covenant of good faith and fair dealing implied in the contract." *Id.*, at 571 (citing *Egan*). As noted in the Ninth Circuit's decision, California courts have recognized the applicability of the *Rawlings* analysis under California insurance bad faith law. *See* Pet. App. at 6a n.4, citing *dicta* in *McMillin Scripps North Partnership v. Royal Ins. Co. of America*, 19 Cal. App. 4th 1215, 1223, 23 Cal. Rptr. 2d 243, *reh'g denied*, 1993 Cal. App. LEXIS 1102 (1993) and *rev. denied*, 1994 Cal. LEXIS 552 (Cal. Feb. 3, 1994).[10]

Any fair reading of the decision below does not support National Union's contention that the Ninth Circuit extended California law or created a new cause of action. Rather, in reviewing the jury's verdict under the applicable "substantial evidence" standard, the court below applied bad faith principles established by the California Supreme Court some fifteen years ago, in *Egan*, to the facts presented here. *Landes Constr. Co. v. Royal Bank of Canada*, 833 F.2d 1365, 1371 (9th Cir. 1987) (applicable standard of review is "substantial evidence").

Accordingly, no basis exists for this Court to exercise its jurisdiction and upset the judgment below.

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[10] The Ninth Circuit cited *McMillin Scripps North Partnership* in connection with its statement that "California courts have acknowledged, albeit in dicta, that there may be circumstances under which an insurer could be liable to its insured for tortious bad faith even where the insurer has not violated an express provision in its policy." Pet. App. at 6a n.4. In this case, by contrast, the jury expressly found that National Union had breached its policy.

## II. THE CALIFORNIA SUPREME COURT DECISION CITED BY THE PETITIONER DOES NOT REQUIRE VACATUR OF THE JUDGMENT BELOW.

Contrary to Petitioner's contention, the California Supreme Court's decision in *Waller v. Truck Insurance Exchange*, 11 Cal. 4th 1, 44 Cal. Rptr. 2d 370 (1995), is not controlling as to the issues decided by the Ninth Circuit below. Accordingly, there is no basis to grant Petitioner's request to vacate the judgment below. The Ninth Circuit apparently agrees. Two weeks ago, that court denied National Union's motion for leave to file an untimely petition for rehearing and suggestion of rehearing *en banc* in light of the *Waller* decision.

*Waller* provides no ground to upset the jury's verdict in this case. *Waller* stands for the proposition that an insurer which *denies coverage* and refuses to defend its insured or otherwise get involved in a case where there is no potential for coverage cannot be held liable for bad faith. Here, National Union never denied coverage, and it certainly did not refrain from taking action in the underlying litigation. Instead, National Union affirmatively injected itself into the underlying litigation against American Medical and its director, Harold Williams, in order, as the jury found, to minimize its liability and prejudice American Medical, its insured. As the Ninth Circuit specifically noted, "[i]f [National Union] wanted to dispute coverage it could and should have filed an action for declaratory relief. Instead, it chose to involve itself in the underlying litigation in a way that the jury in the instant bad faith action apparently found to be both self-serving and prejudicial to the interests of [National Union's] insured." Pet. App. 7a.

*Waller* does not preclude a bad faith claim where, as here, an insurer purportedly provides benefits under the guise of the policy but in reality uses the policy to affirmatively damage its insured.

Moreover, the unstated premise of National Union's argument—that there was no coverage—is directly con-

trary to National Union's own conduct and the jury's special verdict finding that National Union in fact breached its contract of insurance. National Union's coverage defenses—the same ones it asserts here—were properly rejected by the jury and by the District Court in denying National Union's post-trial motions. These findings were supported by more than substantial evidence. The Ninth Circuit affirmed, and there is no reason to vacate that decision here.

**A. The Ninth Circuit Has Determined That Petitioner's Arguments Based On The California Supreme Court's *Waller* Decision Do Not Constitute Good Cause To Grant Leave To Seek Rehearing In That Court.**

The thrust of National Union's entire petition is that the Ninth Circuit's application of California law would have resulted in a reversal of the jury's verdict if only the court had had the benefit of the *Waller* decision at the time of the appeal. However, National Union has already provided the Ninth Circuit with that decision and the identical arguments it makes here in a motion filed with the Ninth Circuit simultaneously with the filing of this petition. App. 2a. In the motion, National Union sought leave to file an untimely petition for rehearing, along with a petition for rehearing and a suggestion for rehearing *en banc*, pursuant to Fed. R. App. P. 26(b), 35 & 40(a). In that pleading, Petitioner presented to the Ninth Circuit the identical argument that the *Waller* decision requires reconsideration of its memorandum decision in this case. App. 2a. By order filed on October 6, 1995, the Ninth Circuit denied Petitioner's motion. App. 1a.

The Ninth Circuit's denial underscores the correctness of the decision below and illustrates that *Waller* simply is not applicable to the facts and legal issues presented in this case.

**B. The *Waller* Decision Is Inapplicable To The Matters At Issue Here.**

In its petition, National Union attempts to stretch *Waller* beyond the scope of the holding in that decision. In fact, *Waller* provides no basis to overturn the jury's verdict in this case. In *Waller*, the California Supreme Court granted review to determine "whether a commercial general liability insurer is required to defend a third party action that seeks incidental emotional distress damages caused by the insured's noncovered economic or business torts." 44 Cal. Rptr. 2d at 372. The Court held that the insurer had no duty to defend the action because those claims raised no potential for coverage under the bodily injury or property damage coverage grants in a general liability policy. The Court also held that a bad faith claim could not exist absent this *potential* for coverage. "It is clear that if there is no *potential* for coverage and, hence, no duty to defend under the terms of the policy, there can be no action for breach of the implied covenant of good faith and fair dealing because the covenant is based on the contractual relationship between the insured and the insurer." *Id.*, at 390 (emphasis in original) (citing *Love v. Fire Ins. Exchange*, 221 Cal. App. 3d 1136, 1151-53, 271 Cal. Rptr. 246, *reh'g denied*, 1990 Cal. LEXIS 4195 (1990)). Thus, the Court held that a bad faith claim cannot be maintained in that situation "unless policy benefits are due." *Id.*

National Union's effort to expand *Waller* beyond its holding to cover this case should be rejected. National Union's conduct is far different from that of the insurer in *Waller*, who did nothing more than deny a defense for what turned out to be a non-covered claim in any event. National Union never denied coverage for American Medical's claim.[11] Instead, National Union intruded itself

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[11] National Union's senior claims official testified by way of deposition read at the trial that "*We never denied the claim and we are not denying the claim currently.*" Supp. 88 (emphasis added).

into the underlying case and entered into an agreement that severely *prejudiced* its insured. Through its Mary Carter arrangement, National Union gave the underlying plaintiff an incentive to pursue American Medical with more vigor due to the guaranteed liability agreement, and indeed, put American Medical in a *worse* position than it would have been had National Union taken no action at all, *i.e.*, had National Union merely denied coverage and taken no further action, like the insurer in *Waller*.

The jury's finding of bad faith under the facts of this case was firmly grounded in California and Ninth Circuit precedent. As the Ninth Circuit stated: "[National Union's] guarantee agreement with Pearce [the underlying plaintiff] had essentially the same effect as Transamerica's agreement with the plaintiff in *Matison* [*v. Transamerica Title Ins. Co.*, 845 F.2d 867 (9th Cir. 1988)], *i.e.*, to encourage the plaintiff to pursue its possibly uncovered claims against an insured in the hopes of reducing or eliminating the insurer's liability." Pet. App. 6a. The Ninth Circuit thus found that, because the jury could reasonably have concluded on the evidence that National Union "had engaged in a scheme to benefit at the expense of its insured," substantial evidence supported the bad faith finding against National Union. Pet. App. 6a-7a.

Thus, unlike the insurer in *Waller*, National Union did not deny coverage, but cut a separate deal with the underlying plaintiff, at the expense of its own insured, American Medical. National Union was held liable for breach of contract and bad faith based on more than substantial evidence. Nothing in *Waller* forecloses a California court from imposing bad faith liability against an insurer where the insurer actively engages in misconduct designed to benefit itself and cause detriment to its insured.[12]

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[12] The proposition that an insurer that takes unreasonable action injurious to its insured can be liable for bad faith has been recognized in more than one California decision. *See, e.g., McMillin*

### C. Even If *Waller* Were Otherwise Applicable It Would Not Change The Result In This Case.

National Union's petition obviously implies that there was no coverage under its policy for the underlying claim. Here, however, unlike the situation in *Waller*, there *was* coverage under the policy. National Union presented each of its coverage arguments during the trial, again to the District Court in post-trial motions, and to the Ninth Circuit on appeal. In each case, the arguments were rejected, and for good reason. The underlying Pearce litigation presented exactly the type of claim covered by National Union's policy, and National Union repeatedly took the position that it was fulfilling its obligations under the policy. National Union's representatives never denied coverage during the pendency of the Pearce litigation, and National Union's senior claims representative testified at the trial below that National Union still was not denying coverage for the claim. In fact, National Union maintained at trial and on appeal that it *had* provided policy benefits by entering into the Mary Carter agreement against its own insured.

The jury explicitly found that National Union had breached its insurance contract and the implied covenant of good faith and fair dealing in taking the action against American Medical. Pet. App. 13a. After denying National Union's post-trial motions, the District Court entered judgment on the jury's verdict. Pet. App. 15a. The Ninth Circuit affirmed the verdict, which it found to be based on substantial evidence. Pet. App. 7a. National Union's attempt to rely on California precedent (including *Waller*) addressing the viability of a claim for breach of the covenant of good faith and fair dealing in the absence of the *potential* for coverage under the policy is thus wholly misplaced here.

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*Scripps North Partnership, supra; Murray v. State Farm Fire & Cas. Co.*, 219 Cal. App. 3d 58, 65-66, 268 Cal. Rptr. 33 (1990).

## CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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# APPENDICES

## APPENDIX A

[Filed Oct. 6, 1995]

## IN THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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No. 93-56382

D.C. No. CV-92-157-ER
(Central California)

AMERICAN MEDICAL INTERNATIONAL, INC.,
*Plaintiff-Appellee,*

v.

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.,
*Defendant-Appellant.*

---

## ORDER

Before: SCHROEDER and KLEINFELD, Circuit Judges, and KING,* District Judge.

The Motion for Leave to File Untimely Petition for Rehearing; Petition for Rehearing and Suggestion for Rehearing En Banc is DENIED.

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* Honorable Samuel P. King, Senior United States District Judge for the District of Hawaii, sitting by designation.

**APPENDIX B**

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

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93-56382

AMERICAN MEDICAL INTERNATIONAL, INC.,
*Plaintiff and Appellee,*

*vs.*

NATIONAL UNION FIRE INSURANCE COMPANY
OF PITTSBURGH, PA.,
*Defendant and Appellant.*

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Appeal from the United States District Court
for the Central District of California
Case No. CV 92-157-ER(EEx)
Edward Rafeedie, Judge

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# MOTION FOR LEAVE TO FILE UNTIMELY PETITION FOR REHEARING; PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC

[Fed. R. App. P. 26(b), 35 & 40(a)]

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IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

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93-56382

AMERICAN MEDICAL INTERNATIONAL, INC.,
*Plaintiff and Appellee,*

*vs.*

NATIONAL UNION FIRE INSURANCE COMPANY
OF PITTSBURGH, PA.,
*Defendant and Appellant.*

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# MOTION FOR LEAVE TO FILE UNTIMELY PETITION FOR REHEARING; PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC

[Fed. R. App. P. 26(b), 35 & 40(a)]

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## INTRODUCTION AND STATEMENT OF COUNSEL

Defendant and appellant National Union Fire Insurance Company of Pittsburgh, Pa. ("National Union") requests leave to file an untimely petition for rehearing. In the opinion of counsel, leave to file an untimely petition for rehearing should be granted so that the panel can reconsider its May 17, 1995 memorandum of decision in light of *Waller v. Truck Insurance Exchange,* No. S042287, 1995 WL 516406 (Cal. Aug. 28, 1995), a recent decision by the California Supreme Court which establishes this court erred in recognizing a new state law

cause of action. *See Huddleston v. Dwyer*, 322 U.S. 232, 236 (1944); *Braniff Airways, Inc. v. Curtiss-Wright Corp.*, 424 F.2d 427, 429-30 (2d Cir. 1970), *cert. denied sub. nom. Addabbo v. Curtiss- Wright Corp.*, 400 U.S. 829 (1970).

In its memorandum of decision, the panel affirmed a $12 million judgment in favor of plaintiff and appellee American Medical International, Inc. ("American Medical") in a diversity action for breach of insurance contract and breach of the implied covenant of good faith and fair dealing. In that action, American Medical claimed National Union breached the good faith covenant in an excess directors and officers liability policy by settling a suit against an American Medical director, Harold Williams, over American Medical's objection.

National Union argued, inter alia, the judgment should be reversed because it owed no policy benefits to either American Medical or Williams and because the district court refused to either instruct the jury or grant National Union's motions for directed verdict on its policy's coverage. The panel rejected those arguments and declined to address the coverage issues. Relying on dictum in an intermediate California Court of Appeal decision and a decision of this court which applied *Arizona* law, the panel held that under California law, an insurer may be found liable for breach of the implied covenant even if no policy benefits are owed.

On July 13, 1995, the panel denied National Union's timely petition for rehearing. On August 4, 1995, however, the panel granted a 60-day stay of mandate pending the filing and disposition of a petition for certiorari to the United States Supreme Court. National Union's petition for certiorari was filed on September 15, 1995.

On August 28, 1995, the California Supreme Court filed its opinion in *Waller*. *Waller* specifically held that under California law, an action for breach of the implied

covenant of good faith and fair dealing cannot be maintained in the absence of a duty to defend or indemnify.

Because *Waller* establishes that the panel erred in concluding the California Supreme Court would recognize a cause of action for breach of the implied covenant in an insurance contract when no policy benefits are owed, the panel is obligated under controlling Supreme Court precedent to grant National Union's motion to file an out-of-time petition for rehearing and reconsider its earlier ruling. *Huddleston*, 322 U.S. at 236. If the panel denies rehearing, the court should rehear this matter en banc to conform Ninth Circuit law with the rule articulated by the Supreme Court that, so long as the case remains sub judice, a federal court of appeals sitting in diversity is obligated to consider an out-of-time petition for rehearing when an intervening state court decision calls into question the court of appeals' understanding of state law. *See Carter v. Derwinski*, 987 F.2d 611, 613-15 (9th Cir. 1993) (en banc) (overruling circuit precedent inconsistent with prior supreme court authority).

## LEGAL DISCUSSION

### I. THIS COURT IS OBLIGATED TO GRANT LEAVE TO FILE AN UNTIMELY PETITION FOR REHEARING WHEN AN INTERVENING STATE COURT DECISION CALLS INTO QUESTION THIS COURT'S UNDERSTANDING OF STATE LAW. THE COURT SHOULD GRANT LEAVE EVEN THOUGH A PETITION FOR CERTIORARI IS PENDING.

A party ordinarily has fourteen days from entry of judgment to file a petition for rehearing. Fed. R. App. P. 40(a). This time period may be enlarged, however, upon "good cause shown." Fed. R. App. P. 26(b); *see also* Fed. R. App. P. 35(c), 40(a). Supreme Court precedent establishes that a federal court of appeals sitting in diversity not only may but *must* consider an out-of-time petition for rehearing when an intervening state court de-

cision calls into question the federal court's understanding of state law so long as the federal case is still sub judice.

The leading case is *Huddleston v. Dwyer*, 322 U.S. 232 (1944). *Huddleston* involved a diversity action that turned on application of Oklahoma law. Following entry of judgment in the Tenth Circuit, defendants filed a timely petition for rehearing that was denied. A month and a half later, the Oklahoma Supreme Court handed down a decision that cast doubt on the Tenth Circuit's understanding of Oklahoma law. Defendants then sought leave to file a second, untimely petition for rehearing with the Tenth Circuit. That petition was also denied. Applying the rule that " '[u]ntil such time as [the] case is no longer sub judice, the duty rests upon federal courts [exercising diversity jurisdiction] to apply state law . . . in accordance with the then controlling decision of the highest state court,' " *id.* at 236 (second alteration in original) (quoting *Vandenbark v. Owens-Illinois Glass Co.*, 311 U.S. 538, 543 (1941)), the United States Supreme Court vacated the Tenth Circuit judgment and remanded with instructions for the court of appeals to reconsider its decision in light of the intervening state law decision, *id.* at 237-38.[1]

In *Braniff Airways, Inc. v. Curtiss-Wright Corp.*, 424 F.2d 427 (2d Cir. 1970), *cert. denied sub nom. Addabbo v. Curtiss-Wright Corp.*, 400 U.S. 829 (1970), the Second Circuit, following *Huddleston*, considered an

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[1] The Supreme Court reaffirmed the propriety of this practice more recently in *Exxon Co., U.S.A. v. Banque de Paris et des Pays-Bas*, 488 U.S. 920 (1988). There the Fifth Circuit, in a diversity case, issued a decision turning on a question of Texas law. Thereafter, the Texas Court of Appeals, in a different case, decided the question contrary to the Fifth Circuit's understanding of Texas law. The losing party before the Fifth Circuit petitioned the Supreme Court for a writ of certiorari, which the court granted. After briefing, the Supreme Court vacated the Fifth Circuit judgment and remanded for further consideration in light of the intervening state court decision.

out-of-time petition for rehearing under a fact pattern virtually identical to that presented by this case. *Braniff* involved a diversity action that turned on application of Florida law. Following entry of judgment in the Second Circuit, defendants filed a timely petition for rehearing. Three weeks after the petition was denied, the Florida Supreme Court reversed a lower court decision upon which the court of appeals had relied in construing state law. Defendants filed a petition for certiorari and later filed a request in the court of appeals for " 'modification of decision of the court or for enlargement of the time to petition for rehearing.' " *Braniff Airways, Inc.*, 424 F.2d at 429 (quoting plaintiffs' motion). After the Supreme Court denied certiorari, the Second Circuit granted the request for rehearing.

The court first held it had

> the power to enlarge the time to petition for rehearing . . . and to modify an erroneous decision although the time for rehearing may have expired. . . .
>
> This Circuit has long shown considerable willingness to correct what it believed an erroneous interpretation of the law when an intervening state decision seemed to indicate a better view.

*Id.* at 429.

The court then considered whether it should entertain a request for rehearing when a petition for certiorari had already been filed:

> *Huddleston* seems to indicate that we should. Instead of reversing the court of appeals, and deciding the state law issues itself, the Supreme Court there vacated the court of appeals decision, and remanded to that court to permit it to determine the issues of state law in the first instance, on the basis of the new state court decision. *For us to refuse to consider petitions for rehearing under the circumstances present*

> *here merely because a petition for certiorari has been filed would be, it seems to us, wasteful, for under the* Huddleston *procedure the Supreme Court would not reach the merits of the controversy, but would vacate our decision and order us to reconsider on the basis of the recent state opinion.*

*Id.* at 429-30 (emphasis added).[2]

In sum, under *Braniff*, this case remains sub judice and the court must entertain an out-of-time petition for rehearing even though a petition for certiorari has been filed. (Indeed, because the panel in this case stayed the mandate for only 60 days pending the filing of a petition for certiorari, it was necessary for National Union to file its petition for certiorari to prevent the mandate from issuing.) Under *Huddleston*, the panel is obligated to reconsider its prior decision if the California Supreme Court's decision in *Waller v. Truck Insurance Exchange* at least calls that ruling into question. It plainly does, for the reasons set forth in Part II below.

We urge the panel to promptly reconsider its ruling in light of *Waller*, thereby fulfilling its *Huddleston* obligation and forestalling the "wasteful" scenario outlined in *Braniff*, i.e., a grant of certiorari by the Supreme Court, followed by vacatur of the panel's judgment and remand for reconsideration in light of *Waller*. However, as *Braniff*

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[2] *See also* 2A Federal Procedure, Lawyers Edition § 3:840, at 479 (1994) (citations omitted).

> [A] Court of Appeals does have . . . the power to modify an erroneous decision, even though the time for a rehearing may have expired. It has even been held that a Court of Appeals has the power to consider a petition for rehearing, although a petition for certiorari has already been filed with the Supreme Court, since it is less wasteful of judicial effort for the Court of Appeals to grant the rehearing than it is for the Court of Appeals to wait for the Supreme Court to vacate its judgment and remand.

*Id.*

establishes, the court retains the authority to entertain and grant the petition for rehearing even if the Supreme Court denies certiorari before a ruling on the rehearing petition.

## II. THE CALIFORNIA SUPREME COURT'S OPINION IN *WALLER* ESTABLISHES THAT THE PANEL ERRED IN CONCLUDING THE CALIFORNIA SUPREME COURT WOULD RECOGNIZE A BAD FAITH CAUSE OF ACTION WHERE NO POLICY BENEFITS ARE OWED.

In its appeal, National Union argued that under California law, it could not be liable for breach of the implied covenant of good faith and fair dealing if no policy benefits were owed. It contended no policy benefits were owed to either Williams or American Medical because: (a) the $10 million limits of the underlying primary policy were not exhausted; (b) the National Union directors and officers liability policy expressly excluded claims arising out of acts to prevent the acquisition of the corporation and claims by former directors; and (c) the policy entitled American Medical to benefits only if American Medical indemnified Williams for his liability, which American Medical had refused to do. National Union also contended the district court committed reversible error by refusing to either instruct the jury or grant its motions for directed verdict on its policy's coverage.

The panel found it unnecessary to address National Union's coverage arguments. It held that under California law, an insurer may be liable to its insured for breach of the implied covenant even if it did not withhold any policy benefits from American Medical. (Mem. of Decision at 6 n.4, 7-8.) The panel based its conclusion solely on dictum in *McMillin Scripps North Partnership v. Royal Insurance Co. of America*, 23 Cal. Rptr. 2d 243, 247 (Cal. Ct. App. 1993), an intermediate California Court of Appeal decision, "that 'there may be unusual

circumstances' " in which bad faith liability could be imposed where no policy benefits were owed, and *Matison v. Transamerica Title Insurance Co.*, 845 F.2d 867 (9th Cir. 1988), a decision which applied *Arizona* law.

*Waller v. Truck Insurance Exchange*, No. S042287, 1995 WL 516406 (Cal. Aug. 28, 1995), decided after the panel denied National Union's earlier petition for rehearing, establishes that *Matison* and the dictum in *McMillin* are contrary to California law. In *Waller*, the insurer refused to defend its insureds in a business dispute over corporate control. The insureds sued the insurer claiming, inter alia, that its denial of a defense breached the implied covenant of good faith and fair dealing. After determining that the insurer was under no duty to defend or indemnify, the California Supreme Court affirmed the holding of the court of appeal that there could be no breach of the implied covenant in the absence of obligations under the policy. It held:

> [I]f there is no *potential* for coverage and, hence, no duty to defend under the terms of the policy, there can be no action for breach of the implied covenant of good faith and fair dealing because the covenant is based on the contractual relationship between the insured and the insurer. . . . [The] "conclusion that a bad faith claim cannot be maintained unless policy benefits are due is in accord with the policy in which the duty of good faith is [firmly] rooted." . . . The legal principle is based on general contract law and the long-standing rule " 'that neither party will do anything which will injure the right of the other to receive the benefits of the agreement.' " . . . In sum, the covenant is implied as a supplement to the express contractual covenants, to prevent a contracting party from engaging in conduct that frustrates the other party's rights to the benefits of the agreement . . . *Absent that contractual right . . . the implied covenant has nothing upon which to act as a supplement, and "should not be endowed with an*

> *existence independent of its contractual underpinnings."*

*Id.* at *21 (citations omitted) (third alteration in original).

Thus, the California Supreme Court has clearly and squarely rejected the interpretation of California law adopted in the panel's May 17, 1995 memorandum decision. That decision is not " 'in accordance with the . . . controlling decision of the highest state court' " and must be reconsidered. *Huddleston v. Dwyer,* 322 U.S. at 236 (quoting *Vandenbark v. Owens-Illinois Glass Co.,* 311 U.S. at 543). This court is therefore obligated to grant National Union's motion and petition and "conform [its] order[] to the state law." *Vandenbark,* 311 U.S. at 543.

## CONCLUSION

For all the foregoing reasons, the motion for leave to file an untimely petition for rehearing should be granted so that the panel may promptly reconsider its decision in light of the California Supreme Court's decision in *Waller v. Truck Insurance Exchange,* thereby obviating the need for the Supreme Court to grant National Union's pending petition for certiorari and remand the case for reconsideration under *Waller.*

If the panel denies rehearing, the court should rehear this matter en banc to conform Ninth Circuit law with the rule articulated by the Supreme Court in *Huddleston v. Dwyer* that a federal court of appeals must follow the controlling decision of the highest state court and must consider an out-of-time petition for rehearing when an intervening state court decision calls into question the federal court's understanding of state law.

Dated: September 20, 1995

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